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Internal Revenue Service

memorandum

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to: Chief, Examination Division, Southern California District
District Technical Coordinator E:TC
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from: District Counsel, Southern California District, Laguna Niguel
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subject: Income on excess contributions to Education IRAs and Roth IRA conversion income

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ISSUES

The following questions have been submitted by the Southern California District's Technical Coordinator:

1. Who is taxable on income earned on excess contributions to an education IRA, the beneficiary or the contributor?

2. Using the annualized income installment method of payment of estimated taxes, when does a taxpayer include in income the taxable portion of an IRA distribution resulting from a conversion from a traditional IRA to a Roth IRA?

CONCLUSIONS

1. The beneficiary must report any income earned on excess contributions to an education IRA.

2. The taxpayer should treat the income from the conversion of a traditional IRA to a Roth IRA as if it were realized during the quarter in which the initial conversion election was made.

FACTS

During [redacted], the taxpayer made excess contributions to an education IRA for his minor child. The excess contributions earned income while in the education IRA. Eventually, the excess contributions and the income earned by them were distributed. The facts as presented do not indicate whether the distribution was to the contributor or the beneficiary.

In [redacted], the taxpayer converted his traditional IRA to a Roth IRA. The conversion resulted in a deemed distribution that included taxable amounts. The taxpayer chose to include the taxable portion of the distribution from the traditional IRA over four years as provided by I.R.C. § 408A(d)(3)(A)(iii).

DISCUSSION

The Taxpayer Relief Act of 1997, P.L. 105-34, added new I.R.C. §§ 408A and 530, which were modified by the IRS Restructuring and Reform Act of 1998, P.L. 105-206, effective for tax years beginning after December 31, 1997. These sections permit the formation of two new types of IRA, the Roth IRA and the education IRA. Your request for advice includes questions regarding both types of IRA. We will answer each in turn.

The Education IRA issue:

The education IRA provisions allow $500 per year to be set aside for the education of a minor, and the income earned on the money while in the education IRA is not taxed. Nor will the distributions be taxed so long as the beneficiary's qualified education expenses for the year of distribution are equal to or greater than the distributions received that year.

No more than $500 may be set aside for each beneficiary during each year, regardless of the number of contributors or the number of separate education IRA accounts created for the individual beneficiary. If the contributions in excess of this limit (and any earnings attributable to them) are not withdrawn from the child's account (or accounts) before the tax return for the year is due, the excess contributions are subject to a 6 percent excise tax under section 4973 for each year the excess amount remains in the account. IRS Publication 590 dealing with individual retirement accounts states on page 46 that the beneficiary should report any income earned on excess contributions and then distributed on the beneficiary's return for the year in which the excess contribution was made. On page 48, however, the publication states that the contributor should report the income.

Section 530(d)(1) provides that any distribution from an education IRA shall be includible in the gross income of the "distributee,"[1] without explaining who the "distributee" should be. Thus, the statute does not appear to explicitly require distribution to the beneficiary. Generally, however, contributions to education IRAs should be treated as gifts to the beneficiary because the transferee has parted with all right and title to the money contributed. See Burnet v. Guggenheim, 228 U.S. 280 (1933); Sanford Est. v. Commissioner, 308 U.S. 39 (1939); Smith v. Shaughnessy, 318 U.S. 176 (1943). Thus, distributions from education IRAs should be made only to beneficiaries.

Section 530(d)(4)(A) supports the conclusion that the beneficiary should report the income. It provides for a 10% penalty on distributions that have to be included in gross income because they are in excess of the beneficiary's qualified education expenses for that year. Section 530(d)(4)(C) excludes from this penalty distributions of recent contributions. To qualify for this exclusion the distribution must include both the amount of the recent contribution and any income earned by it. In addition, the distribution must be made on or before the due date for the beneficiary's return for the year of the contribution, or, if the beneficiary is not required to file a return, the 15th day of the 4th month following the end of the taxable year. By referring to the due date of the beneficiary's return, this subsection implies that the beneficiary should include any income on his or her return if necessary. Were this

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[1] The income is to be included in the manner provided in section 72. Section 72 provides general rules for determining the taxable and nontaxable portions of payments received pursuant to annuity contracts--essentially prorating the recipient's basis in the contract.

not the intended result, it would be more appropriate to refer to the due date for the contributor's return--or, perhaps, the distributee's.

We note that a footnote in the Conference Committee's report says that excess contributions are to returned to the contributor. We have coordinated this issue with the National Office and have been told that this footnote is incorrect. Apparently, an earlier draft of the bill required a return to the contributor, but the technical corrections staff changed the provision. This footnote is probably the source of the confusion and the statement on page 48 of Publication 590. The national office has also told us that the statement on page 48 requiring the contributor to report the income on the excess contribution is incorrect and that an errata sheet has been published regarding Publication 590.

The Roth IRA issue:

A Roth IRA, like a traditional IRA, is a retirement plan and shares some characteristics with a traditional IRA, such as the fact that earnings are not currently taxed. The Roth IRA differs from the traditional IRA in three notable ways: 1. Contributions are never deductible, regardless of the income level of the owner; 2. Distributions are not taxable, provided certain requirements are met; and 3. The mandatory distribution rules do not apply.

Section 408A(c)(3)(B) allows a taxpayer to transfer assets from a traditional IRA to a Roth IRA in a qualified rollover contribution provided the taxpayer has an AGI of under $100,000 for the year of the rollover contribution and is not a married taxpayer filing a separate return. Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of section 408 and section 408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs with the same trustee. Treas. Reg. § 1.408A-4 A-1(c) (Final regulation published February 4, 1999, T.D. 8816, 1999-8 I.R.B. 4); <u>see also</u> section 408A(d)(3)(C). Treating the converted amount as a distribution results in taxation of the previously earned, but untaxed, income in the traditional IRA. This is done because contributions to a Roth IRA cannot be deducted. Taxing this income puts the initial rollover contribution on a parity with other nondeductible contributions to Roth IRAs.

Section 408A(c)(7) provides, in a subsection entitled "Time when contributions made," that, for purposes of section 408A, the rule of section 219(f)(3) shall apply. That rule provides that contributions are treated as made on the last day of the year to which applicable so long as actually made before the due date of the return. It is not clear that one can extrapolate from this to conclude that the distribution from the traditional IRA that is funding the contribution should also be deemed to occur on the same date. It does seem clear, however, that the underpayment of estimated tax penalty under section 6654 can apply to income derived from early IRA distributions. Swaim v. Commissioner, T.C. Memo. 1996-545. Consequently, it is reasonable to assume that an early IRA distribution would be treated like any other income item: The taxpayer should make the estimated tax payment for the quarter in which the distribution is received if using the annualized income installment method under section 6654(d)(2). This result does not seem inequitable when one considers that the taxpayer has complete control over the timing of the distribution. In addition, we have coordinated our response with the National Office, and technical personnel in the National Office support this conclusion.

CONCLUSIONS

1. The beneficiary must report any income earned on excess contributions to an education IRA that are then distributed to avoid the 6% excise tax.

2. For estimated tax purposes the taxpayer should treat the income from the conversion of a traditional IRA to a Roth IRA as if it were realized during the quarter in which the initial conversion election was made.